88-1117

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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1988

No._____

VINCENT E. OSWALD,

Petitioner,

V.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

I. Whether the split in the Circuits should be resolved to determine if a distribution check issued to a taxpayer constitutes taxable income when neither the funds to cover the check exist nor the taxpayer has realized any gain from the check.

II. Whether the split in the Circuits should be resolved, in light of this Court's decision in Eisner v. Macomber, 252 U.S. 189 (1920), to determine if a distribution made to a taxpayer can be recharacterized as non-income when the tax benefits to be received were later determined to be unavailable, and in fact were never available.

PARTIES TO THIS PROCEEDING IN THE COURT BELOW

This action, as filed in the United States Court of Appeals for the Third Circuit, was styled Vincent E. Oswald, Appellant, v. Commissioner of Internal Revenue, at No. 88-1252.

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Johnson v. Commissioner, 25 T.C. 499 (1955)

Rutkin v. U.S., 343 U.S. 130, 137, 72 S. Ct. 571, 575 (1952)

R. J. Tricon Co., Inc. v. U.S., 572 F. Supp. 1050 (E.D. La. 1983)

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OPINIONS BELOW

The United States Court of Appeals For The Third Circuit issued a Judgment Order on September 8, 1987. A copy of the Order is contained in the Appendix at pp. 1a-2a.

STATEMENT OF JURISDICTION

The Judgment of the United States Court of Appeals for the Third Circuit was entered on September 19, 1988.

The Judgment of the United States Court of Appeals for the Third Circuit is thus final with respect to the issues presented here. There is an important question of federal law which has not been, but should be settled by this court. The issues are therefore ripe for review.

The Jurisdiction of the Supreme Court of the United States is invoked under Title 28, United States Code Section 2101 (c).

STATEMENT OF THE CASE

Procedural

In a statutory notice of deficiency dated April 13, 1984, the Commissioner determined that Petitioner had a deficiency of 1980 Federal income tax liability in the amount of $95,806.54. The taxpayer filed a timely petition to the Tax Court on July 12, 1984. Jurisdiction of the Tax Court was invoked pursuant to Sections 6213(a) and 7442 of the Internal Revenue Code of the 1954 (26 U.S.C.S.). By amendment to his answer, the Commissioner increased his determination of taxpayers deficiency to $105,494.

The Tax Court entered its Memorandum Findings of Fact and Opinion on September 8, 1987. The Tax Court's decision was entered on December 23, 1987. The Taxpayer timely filed a Notice of Appeal on

March 17, 1988. The jurisdiction of the United States Court of Appeals for the Third Circuit was involved pursuant to Section 7482(a) of the Internal Revenue Code of 1986.

On September 19, 1988, the United States Court of Appeals for the Third Circuit affirmed the decision of the tax court. This Petition followed.

Background

During the years 1977 through 1980, petitioner was the president and sole shareholder of Shop Materials Company, Inc. ("Shop"). From its inception in 1957 until January 31, 1976, Shop was treated for Federal income tax purposes as a corporation under subchapter C of the Code. As of January 31, 1976, Shop had accumulated earnings and profits of $306,014.

In February of 1976, Shop elected to be treated as a small business corporation under subchapter S of the Code. The election became effective for its taxable year beginning on February 1, 1976.

During the years 1977 through 1980, petitioner was also a shareholder and chairman of the board of directors of Electrical M&R, Inc. ("Electric"), a publicly held corporation. During 1980, petitioner and his wife owned 29.04 percent of Electric's common stock and were the corporation's largest shareholders. Petitioner's daughter who owned 5.99 percent of the stock was Electric's second largest shareholder.

Before 1980, petitioner and Shop had loaned money to Electric to cover operating expenses. As of December 31, 1979, the

outstanding principal balance of the loans by Shop to Electric was $368,063.76.

Pursuant to Shop's status as an electing small business corporation, petitioner properly included the undistributed taxable income for each year in gross income on his and his wife's joint Federal income tax returns. Petitioner also properly reported, as dividend income, distributions from Shop that were made out of the current year's earnings and profits for the taxable years ending January 31, 1979 and 1980. As of January 31, 1980, the books and records of Shop reflected $193,986.05 of cumulative undistributed taxable income previously taxed ("PTI") (which included the $36,281 of undistributed taxable income for the year ending January 31, 1980).

In February of 1980, Shop terminated its election to be treated as a small business corporation effective February 1, 1980. Acting on the advice of their accountant, and with the approval of the bank in which they maintained their checking accounts, petitioner, Shop, and Electric engaged in a series of transactions which were designed to effect a tax-free distribution to petitioner of the $193,986.05 in PTI that was reflected on Shop's books land records as of January 31, 1980. The transactions are described below.

On April 8, 1980, Shop issued a check to Petitioner in the amount of $193,986.05. Shop recorded the payment of the $193,986.05 as a distribution to Petitioner. Petitioner deposited the check in his personal checking account.

On the same day, Petitioner loaned $210,000 to Electric by issuing a personal check in that amount in favor of Electric. The amount of the check was debited to Petitioner's checking account and credited to Electric's corporate checking account at the same bank. In exchange, Electric issued a recourse demand promissory note dated April 8, 1980, in favor of Petitioner, in the amount of $963,265.66. The principal amount of the promissory note represented the outstanding balance of loans Petitioner had made to Electric in years before 1980 in the total amount of $753,265.66, plus the $210,000 loan made on April 8, 1980, in favor of petitioner, in the amount of $963,265.66. The principal amount of the promissory note represented the outstanding balance of loans petitioner had made to Electric in years

before 1980 in the total amount of $753,265.66, plus the $210,000 loan made on April 8, 1980.

The $210,000 loan was reflected as a current liability on Electric's audited financial statements for the year ending December 31, 1980.

In the last relevant transaction that occurred on April 8, 1980, Electric issued a check to Shop in the amount of $225,000. This check was designated as a payment of interest by Electric on loans Electric had received from Shop in earlier years and was so described in Electric's 1980 annual report. The $225,000 check was debited to Electric's checking account and credited to Shop's checking account by the bank.

The balance in the respective checking accounts of petitioner, Shop, and Electric

immediately before the exchange of the checks was as follows:

	Account Balance on April 8, 1980
Petitioner's	$13,363.19
Shop's	31,999.50
Electric's	26,625.43

By prearrangement, the bank covered the checks that were issued by petitioner, Shop, and Electric, by simultaneously crediting their respective accounts with the amount of the checks each received from the other.

REASONS RELIED UPON FOR THE ALLOWANCE OF THE WRIT

I. THE SPLIT IN THE CIRCUITS SHOULD BE RESOLVED TO DETERMINE IF A DISTRIBUTION CHECK ISSUED TO A TAXPAYER CONSTITUTES TAXABLE INCOME WHEN NEITHER THE FUNDS TO COVER THE CHECK EXIST NOR THE TAXPAYER HAS REALIZED ANY GAIN FROM THE CHECK.

As sole shareholder of Shop Materials Company (Shop), Petitioner attempted to make a tax free distribution of all of Shop's current undistributed taxed income (UTI) and previously taxed undistributed taxable income (PTUTI) by issuing a check to himself from Shop in the amount of $193,986.05, on April 8, 1980.

The IRS claims that this attempted distribution, although tax exempt under Sec. 1375(f) to the extent of the UTI of $36,281.05, was ineffective under both Secs.1375(d) and (f) to the extent of the UTI of $36,281.05, and was ineffective under both Secs. 1375(d) and (f) to the extent of

the PTUTI of $157,705.00. Petitioner does not object to the Commissioner's finding that the attempted distribution of the Petitioner's PTUTI failed to meet the requirements of Secs. 1375(d) and (f) but does object to the Commissioner's finding that the failure of the distribution to meet the requirements of Secs.1375(d) and (f) resulted in taxable dividend income to the Petitioner since Petitioner received no income in the distribution.

In Eisner v. Macomber, 252 U.S. 189 (1920) this Court defined income as "the gain derived from capital, from labor, or from both combined, including gains derived from dealings in property and capital assets." In referring to Eisner, the Eighth Circuit limited the Government's ability to expand this income definition in Helvering v. Edison Bros. Stores, 133 F2d. 575, 579 (8th Cir. 1943), where it said:

> The Treasury Department cannot, by interpretative regulations, make income of that which is not income within the meaning of the revenue acts of Congress, nor can Congress . . . tax as income that which is not income within the meaning of the Sixteenth Amendment. Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189 . . . .

Income has been variously defined by the courts. The Third Circuit, in Union Trust Co. v. Commissioner, 115 F.2d 86, 87 (3d Cir. 1940, said that to the economist, income means "the money value of the net accretion in one's economic power between two points of time." One District Court held that income was "a gain or recurrent benefit usually measured in money that derives from capital or labor." Connor v. United States, 303 F.Supp. 1187, 1191 (S.D. Tex. 1969) (emphasis by the court). Yet another District Court found that to be taxable, income must be "actually and substantially derived" and that the concept of "gain" or "profit" is implicit

in the term. Fellows Sals Co. v. U.S., 200 F.Supp. 347, 350 (D. S.D. 1961).

At the very least, one must, therefore, receive an economic benefit or gain from a transaction as a condition precedent to having that receipt taxed to him as income. Petitioner received no "gain". The transaction here represented action to remove from Shop's books certain amounts of income previously earned by it and previously taxed to him. However, even if, as the Commissioner has found, the check distribution did not qualify as a tax-free distribution to the extent of the PTUTI, it does not necessarily follow that the Petitioner has received income.

Prior to the instant transaction, Petitioner had been advised, by Shop's accountant to terminate Shop's Subchapter S status. Since there was no money or other property available to take out of Shop, the accountant recommended book transfers

between Petitioner, Shop and Electric M&R. The net effect was to make a "paper transfer" of all of the previously taxed earnings (PTUTI and UTI) out of Shop. The Commissioner treated the check from Shop to the Petitioner as a distribution to the extent of its face value, presumably because it was "accepted" at the bank, and taxed the Petitioner as if he had personally received money (gain) from Shop. However, the Petitioner did not receive money (gain) or anything of exchangeable value from Shop and as such could not have received income.

Shop had only $31,999.50 (or approximately 15 percent of the face value of the check) on deposit at the bank at the time the check was issued and presented. Because of the three-party transfer, the check was able to clear through the bank without "bouncing" but only after prior notice and approval for the transacton by the bank. At

no time throughout this transaction did any of the parties receive money (or its equivalent) for the checks presented, or anything else which could have been exchanged for equivalent value.

In short, nothing of real value was ever intended to be given to the Petitioner or was in fact received by him.

The Commissioner treated the face amount of the Shop check as taxable, and to the extent it represented PTUTI, as dividend income, although Petitioner received only a worthless check from Shop and a "demand note" of the same or nearly the same face value from Electric M&R. At the time of the demand note receipt, Electric M&R could not pay the note as written and had already owed Petitioner in excess of $750,000.00.

Plainly, there was never any intention or expectation that the demand note would be honored at the time of issuance or later. Accordingly,

Petitioner did not receive income from the note from Electric M&R.

Receipt of a check generally will be sufficient to constitute a constructive receipt of income although not converted to money. However, a check so treated, it may not be encumbered by substantial limitations or restrictions to the taxpayer's control of or receipt of the money. R. J. Tricon Co., Inc. v. U.S., 572 F.Supp. 1050 (E.D. La. 1983). It has long been recognized that lack of available funds of a corporation to pay an obligation does constitute a substantial limitation to the individual's control of the funds. Johnson v. Commissioner, 25 T.C. 499 (1955), as expressed by this Court, Rutkin v. U.S., 343 U.S. 130, 137, 72 S. Ct. 571, 575 (1952), a gain "constitutes taxable income when its recipient has such control over it that, as a practical matter he derives readily realizable economic value from it" and in Safety Car Heating,

supra, where this Court found that income, within the meaning of the Sixteenth Amendment, is "the fruit that is born of capital, not the potency of fruition." 297 U.S. at 99. The unlikely prospect that Petitioner, while currently holding a "demand" note for the sum in question, may yet realize some economic benefit from the transaction, of course does not alter the test that it is realization or "fruit" at the moment of the transaction which defines income not the "potency of fruition."

As the Seventh Circuit recognized in Hirsch v. C.I.R., 115 F. 656 (7th Cir. 1940), "A transaction whereby nothing of exchangeable value comes to or is received by the taxpayer does not give rise to, or create, taxable income", citing Eisner v. Macomber, supra.

The check petitioner received from Shop was not intended to be, nor was it ever, exchanged for money or exchangable for money. The sole

purpose and result of the transaction was to reduce on Shop PTUTI and UTI and remove its locked in earnings.

II. THE SPLIT IN THE CIRCUITS SHOULD BE RESOLVED TO DETERMNE IF A DISTRIBUTION MADE TO A TAXPAYER CAN BE RECHARACTERIZED WHEN THE TAX BENEFITS TO BE RECEIVED WERE LATER DETERMINED TO BE UNAVAILABLE, AND IN FACT WERE NEVER AVAILABLE IN LIGHT OF THIS COURT'S DECISION IN EISNER V. MACOMBER, 252 U.S. 189 (1920).

On April 8, 1980, Petitioner received a check from Shop in the amount of $193,986.05. That amount represented a bookkeeping return of Shop's PTUTI of $157,705.00 and UTI of $36,281.05.

The check was issued by Shop to Petitioner with the understanding it would be a tax-free return to Petitioner of its previously taxed income. The commissioner determined that to the extent that Shop had UTI it was tax free to Petitioner under Sec. 1375 (f), but that to the extent Shop had PTUTI that it was not tax free to Petitioner under either Sec. 1375(d) or Sec. 1375(f).

Section 1375(d) allows an electing small business corporation to distribute tax free "all or

any portion of the shareholder's net share of the corporation's undistributed taxable income for taxable years prior to the taxable year in which such distribution is made." As such, "(a)ny such distribution shall . . . be considered a distribution which is not a dividend . . . "

Section 1375(f) allows a corporation, after the close of its year but on or before "the 15th day of the third month following the close of such taxable year" to distribute money "to a person who was a shareholder of such corporation at the close of such taxable year" and treat it "as a distribution of the corporation's undistributed taxable income for such year."

Both Sections allow a taxpayer to receive tax free distributions from a corporation if these conditions are met, and require a taxable distribution if their conditions are not met. However, both Sections presuppose a distribution to

the shareholder of property or money. Section 1375(f) allows only a distribution of "money" while Sec. 1375(d) presupposes a distribution subject to dividend treatment under Sec. 316(a), which in turn presupposes a distribution of property by defining a dividend to be "any distribution of property." The term property is further defined in Sec. 317(a) and related Regulation to mean "any property (including money, securities and indebtedness to the corporation) other than stock, or rights to acquire stock, in the corporation making the distribution." Reg. Sec. 1.317-1.

As was previously shown at Argument I, supra, Petitioner received nothing of value when the check for $193,986.05 was transferred to him, and thus he cannot be deemed to have received property or money. Accordingly, no distribution recognizable under Secs.1375(d) or (f) could have been received by him.

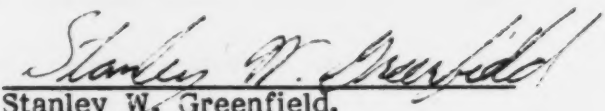
All the Petitioner received was a bookkeeping return on this PTUTI account. A bookkeeping return of Petitioner's PTUTI account cannot be a distribution to him of property, and as such the Petitioner cannot be deemed to have realized dividend income from the check receipt in question.

CONCLUSION

The Court should grant the Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit to decide an important question of federal law which has not been but should be settled by this court.

Respectfully submitted,

GREENFIELD & ASSOCIATES



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CERTIFICATE OF SERVICE

COMMONWEALTH OF PENNSYLVANIA)
) SS:
COUNTY OF ALLEGHENY)

I hereby certify that on the 16th day of December, 1988, three (3) true and correct copies of the foregoing PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT, were served on each of the individuals and in the manner indicated below, which service satisfies the requirements of Rule 28 of the United States Supreme Court Rules.

SERVICE BY FIRST CLASS, UNITED STATES MAIL, POSTAGE PREPAID:

1. Charles Fried
   SOLICITOR GENERAL
   United States Department of Justice
   Room 5143
   Main Justice Building
   Washington, D.C. 20530

2. Gary R. Allen, Esquire
David English Carmack, Esquire
Robert L. Baker, Esquire
James B. Mann, Esquire
Appellate Section
United States Department of Justice
Tax Division
P. O. Box 502
Washington, D.C. 20044

GREENFIELD & ASSOCIATES

Stanley W. Greenfield,
Attorney for Petitioner,
Vincent E. Oswald

SWORN to and subscribed before me

this 16th day of December, 1988.

Notary Public

My Commission Expires:

NOTARIAL SEAL
JANE C. DINDINGER, NOTARY PUBLIC
PITTSBURGH, ALLEGHENY COUNTY
MY COMMISSION EXPIRES JUNE 7, 1992
Member, Pennsylvania Association of Notaries

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 88-1252

VINCENT E. OSWALD,

Appellant,

V.

COMMISSIONER OF INTERNAL REVENUE

Appeal from the United States Tax Court
Washington, D.C.
Tax Court No. 24887-84
(Honorable Stephen J. Swift)

Argued September 8, 1988

Before: BECKER, HUTCHINSON and SCIRICA,
Circuit Judges

JUDGMENT ORDER

After consideration of all contentions raised by appellant, it is

ADJUDGED AND ORDERED that the decision of the tax court be and is hereby AFFIRMED.

Costs taxed against appellant.

BY THE COURT:

_____

Attest:

_____
Sally Mrvos, Clerk
September 19, 1988

T. C. Memo. 1987-448

UNITED STATES TAX COURT

VINCENT E. OSWALD, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24887-84. Filed September 8, 1987.

Steven L. Sablowsky, for the petitioner.

Michael A. Yost, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SWIFT, Judge: In a statutory notice of deficiency dated April 13, 1984, respondent determined a deficiency in the 1980 Federal income tax liability of petitioner and petitioner's now-deceased wife, Eleanor H. Oswald, in the amount of $95,806.54. By amendment to his answer, respondent increased the deficiency to $105,494. At trial, we granted respondent's motion to dismiss

with respect to Eleanor H. Oswald due to her death. After concessions, we must decide whether a check issued to petitioner by his wholly owned corporation constituted a taxable distribution under sections 301 and 316.[1]

FINDINGS OF FACT

Many of the facts have been stipulated and are so found. Petitioner resided in Pittsburgh, Pennsylvania, at the time the petition was filed.

During the years 1977 through 1980, petitioner was the president and sole shareholder of Shop Materials Company, Inc. ("Shop"). Shop is engaged in the sale and repair of electrical equipment. Shop's taxable year ends on January 31. From its inception in 1957 until January 31, 1976, Shop was treated for Federal income tax purposes as a corporation under subchapter C of the Code. As

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1. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as in effect during the year in issue.

of January 31, 1976, Shop had accumulated earnings and profits of $306,014.

In February of 1976, Shop elected to be treated as an electing small business corporation under subchapter S of the Code. The election became effective for its taxable year beginning on February 1, 1976.

Also during the years 1977 through 1980, petitioner was a shareholder and chairman of the board of directors of Electric M&R, Inc. ("Electric"), a publicly held corporation. Electric is engaged in the business of manufacturing, selling, and repairing lighting fixtures, electrical motors, and other electrical equipment. During 1980, petitioner and his wife owned 29.04 percent of Electric's common stock and were the corporation's largest shareholders. The second largest shareholder of Electric was petitioner's daughter who owned 5.99 percent of the stock. During 1980,

the president of Electric was petitioner's son-in-law.

Before 1980, petitioner and Shop had loaned money to Electric to cover operating expenses. As of December 31, 1979, the outstanding principal balance of the loans by Shop to Electric was $368,063.67.

For the taxable years ending January 31 of 1977, 1978, 1979, and 1980, Shop reported taxable income and undistributed taxable income[2] on its Federal small business corporate income tax returns

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2. As explained more fully at pp. 7-8, infra, "undistributed taxable income" is that portion of the taxable income of a subchapter S corporation that is retained by the corporation at the close of the taxable year but that is included in the gross income of the corportion's shareholders.

(Form 1120S) in the following amounts:

Taxable Year Ended	Taxable Income	Annual Undistributed Taxable Income
Jan. 31, 1977	$106,388	$106,388
Jan. 31, 1978	75,321	75,321
Jan. 31, 1979	85,392	5,709
Jan. 31, 1980	56,281	36,281
Cumulative Total		$223,699

Pursuant to Shop's status as an electing small business corporation, petitioner properly included the undistributed taxable income for each year in gross income on his and his wife's joint Federal income tax returns. Petitioner also properly reported, as dividend income, distributions from Shop that were made out of the current year's earnings and profits for the taxable years ending January 31, 1980, the books and records of Shop reflected $193,986.05 of cumulative undistributed taxable income previously taxed ("PTI") (which included the $36,281 of undistributed taxable income for the year ending January 31, 1980).

In February of 1980, Shop terminated its election to be treated as an electing small business corporation effective February 1, 1980. Acting on the advice of their accountant and with the approval of the bank in which they maintained their checking accounts, petitioner, Shop, and Electric engaged in series of transactions which were designed to effect a tax-free distribution to petitioner of the $93,986.05 in PTI that was reflected on Shop's books and records as of January 31, 1980.[3] The transactions are described below.

On April 8, 1980, Shop issued a check to petitioner in the amount of $193,986.05. Shop recorded the payment of the $193,986.05 as a

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3. As indicated in the chart on page 3, the cumulative total amount of Shop's PTI and undistributed taxable income should have been $223,669. Due to a bookkeeping error, the books and records of Shop reflected a cumulative total of $193,986.05, and it was that amount that Shop attempted to distribute in April of 1980 as a tax-free distribution.

distribution to petitioner. Petitioner deposited the check in his personal checking account, and the check was credited by the bank to his account.

On the same day, petitioner loaned $210,000 to Electric by issuing a personal check in that amount in favor of Electric. The amount of the check was debited to petitioner's checking account and credited to Electric's corporate checking account at the same bank. In exchange, Electric issued a recourse demand promissory note dated April 8, 1980, in favor of petitioner, in the amount of $963,265.66. The principal amount of the promissory note represented the outstanding balance of loans petitioner had made to Electric in years before 1980 in the total amount of $753,265.66, plus the $210,000 loan made on April 8, 1980. The promissory note bore a floating interest rate at one percent over prime and was secured by a first lien on substantially all of Electric's assets. The

$210,000 loan was reflected as a current liability on Electric's audited financial statements for the year ending December 31, 1980.

In the last relevant transaction that occurred on April 8, 1980, Electric issued a check to Shop in the amount of $225,000. This check was designated as a payment of interest by Electric on loans Electric had received from Shop in earlier years and was so described in Electric's 1980 annual report. The $225,000 check was debited to Electric's checking account and credited to Shop's checking account by the bank.

The balance in the respective checking accounts of petitioner, Shop, and Electric immediately before the exchange of the checks described above was as follows:

	Account balance on April 8, 1980
Petitioner's	$13,363.19
Shop's	31,999.50
Electric's	26,625.43

By prearrangement, the bank covered the checks described above that were issued by petitioner, Shop, and Electric by simultaneously crediting their respective accounts with the amount of the checks they each received from the other.[4]

On his and his wife's 1980 joint Federal income tax return, petitioner did not include the $193,986.05 check received from Shop in gross income. Instead, petitioner treated the payment from Shop as a nontaxable distribution of PTI. In

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4. Shop also issued to petitioner on April 8, 1980, a check for $28,053.26 which the bank credited to petitioner's account simultaneously with the debits and credits associated with the other checks. The treatment of the $28,053.26 check has not been raised for Federal income tax purposes and is not in dispute in this proceeding.

his notice of deficiency and by amendment to his answer herein, respondent determined that the first $36,281.05 of the $193,986.05 check from Shop represented a tax free distribution to petitioner of Shop's undistributed taxable income for Shop's immediately preceding taxable year. Respondent determined, however, that the $157,705 balance of the $193,986.05 check constituted a taxable dividend to petitioner distributed out of current and accumulated earnings and profits of Shop as a January 31, 1981.

OPINION

Dividends actually distributed by an electing small business corporation must be included in the income of shareholders under the same rules as dividends distributed by regular corporations. Sec. 1.1372-1(c) (2) and (7), Income Tax Regs.; DeTreville v. United States, 445 F.2d 1306,1309 (4th Cir. 1971); Clark v. Commissioner, 58 T. C. 94, 99 (1972);

Roesel v. Commissioner, 56 T.C. 14, 21-22 (1971). Each shareholder of an electing small business corporation also is required to include in gross income the additional amount that would have been received as a dividend if on the last day of the taxable year the corporation had distributed pro rata to each shareholder an amount equal to its "undistributed taxable income" at the end of each taxable year. Sec. 1373(b); Roesel v. Commissioner, supra at 22. "Undistributed taxable income" generally means the taxable income of the corportion minus the taxable distributions made during the taxable year. Sec. 1373(c).[5]

Once the undistributed taxable income of an

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5. Sec. 1373(c) defined "undistributed taxable income" as—taxable income * * * minus * * * the amount of money distributed as dividends during the taxable year, to the extent that any such amount is a distribution out of earnings and profits of the taxable year as specified in section 316(a) (2).

electing small business corporation has been taxed to the shareholders, it becomes PTI and is subtracted from the earnings and profits account and treated like a capital account by the corporation and its shareholders. Clark v. Commissioner, supra at 99-100. After exhausting its earnings and profits for the current year, an electing small business corporation is permitted to make money distributions to its shareholders out of PTI as a nontaxable distribution. Sec. 1375(d)(1);[6] sec. 1.1375-4(b), Income Tax Regs.; Clark v.

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6. Sec. 1375(d) (1) provides as follows:

(d) Distributions of Undistributed Taxable Income Previously Taxed to Shareholders.—

(1) Distributions not considered as dividends.--An electing small business corporation may distribute, in accordance with regulations prescribed by the Secretary, to any shareholder all or any portion of the shareholder's net share of the corporation's undistributed taxable income for taxable years prior to the taxable year in which such distribution is made. Any such distribution shall, for purposes of this chapter, be considered a distribution which is not a dividend, but the earnings and profits of the corporation shall not be reduced by reason of any such distribution.

Commissioner, supra at 100. This is in contrast to the rules applicable to regular corporations that require accumulated earnings and profits from prior years to be exhausted, as well as current year's earnings and profits, before a nontaxable distribution of capital can occur. Sec. 1.316-2(a), Income Tax Regs.

If an electing small business corporation terminates its election to be taxed under subchapter S, distributions subsequent to the effective date of the termination are governed by the regular corporation distribution rules of sections 301 and 316, unless they qualify for the limited exception mentioned below. Sec. 1.1375-4(a), Income Tax Regs.; Estate of Kirk v. Commissioner, 70 T.C. 771, 775 (1978) affd. 634 F.2d 1048 (6th Cir. 1980); Clark v. Commissioner, supra at 101. Thus, a

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(cont.)

distribution that would have been nontaxable under section 1375(d), as a nontaxable distribution of PTI, if the subchapter S election had remained in effect, may be taxable as a dividend out of accumulated earnings and profits if made after the election is terminated. McKelvy v. United States, 201 Ct. Cl. 557, 575, 478 F.2d 1217, 1229 (1973). See also B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 6.08, p. 6-35 (4th ed. 2979).

An exception is provided for distributions made in money and made within two and one-half months after the termination of a subchapter S election. Such distributions may still qualify as nontaxable distributions but only to the extent of undistributed taxable income attributable to the

immediately preceding year. Sec. 1375(f) (1).[7] Based on this rule, as previously explained, respondent treated the portion of Shop's April 8, 1980, distribution that was attributable to Shop's 1980 taxable year (namely $36,281.05) as a nontaxable distribution of undistributed taxable

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7. Sec. 1375(f)(1) provies as follows:

(f) Distributions Within 2 1/2-Month Period After Close of Taxable Year.—

(1) Distributions considered as distributions of undistributed taxable income.—Any distribution of money made by a corporation after the close of a taxable year with respect to which it was an electing small business corporation and on or before the 15th day of the third month following the close of such taxable year to a person who was a shareholder of such corporation at the close of such taxable year shall be treated as a distribution of the corporation's undistributed taxable income for such year, to the extent such distribution (when added to the sum of all prior distributions of money made to such person by such corporation following the close of such year) does not exceed such person's share of the corporation's undistributed taxable income for such year. Any distribution so treated shall, for purposes of this chapter, be considered a distribution which is not a dividend, and the earnings and profits of the corporation shall not be reduced by reason of such distribution.

income. The $157,705 balance of the April 8, 1980, distribution to petitioner was treated as a taxable dividend because the source thereof was deemed to be the current and accumulated earnings and profits on Shop's books as of January 31, 1981. Realizing that the major portion of the distribution Shop made in April of 1980 will not qualify as a nontaxable distribution of PTI, petitioner now attempts to disavow the entire distribution on the grounds that it lacked economic substance.

On the facts before us, we find that a distribution occurred. A check was issued by Shop reflecting payment to Petitioner of the $193,986.05. It was deposited by petitioner into his personal bank account. The check was honored by the bank, and petitioner used the proceeds thereof to make an investment (namely, the $210,000 loan to Electric). Electric reflected the $210,000 as a loan on its audited financial statements, and Electric used the

loan proceeds to make a payment to Shop of accrued interest. Shop used the interest income it received as the source of the funds to cover its check to petitioner.

Without question, a distribution was intended by Shop and by petitioner. Although other transactions were arranged to occur simultaneously with petitioner's receipt of the distribution, the fact of the distribution is not negated.

We have found no authority that would support a recharacterization of the distribution merely because the intended tax benefits are later determined to be unavailable. To the contrary, a number of cases involving fact situations similar to those herein (namely, the termination of a subchapter S election followed by attempts to make distributions that qualify as nontaxable distributions of PTI) have held that the distributions were governed by the regular corporation distribution

rules of sections 301 and 316. See DeTreville v. United States, supra; McKelvy v. United States, supra; Fountain v. Commissioner, 59 T.C. 696 (1973); Clark v. Commissioner, supra; Roesel v. Commissioner, supra; Goodale v. Commissioner, T.C. Memo. 1981-397, 42 T.C.M. 551, 50 P-H Memo T.C. par. 81,397.

Petitioner argues that to tax him on the April 8, 1980, distribution (in excess of the immediately preceding year's undistributed taxable income) will result in double taxation. To the extent, however, that the April 8, 1980, distribution from Shop is taxable, it is attributable to the presence of Shop's current and accumulated earnings and profits at the end of the taxable year in which the distribution was made, and those current and accumulated earnings and profits were never before taxed. The error in petitioner's "double taxation" argument is

further explained in Goodale v. Commissioner, supra, as follows:

> In 1975, petitioners paid tax on certain income which at that time took the character of previously taxed undistributed income, a contribution to capital which reduced the corporation's earnings and profits in that year to zero and which is reflected in the adjusted basis of petitioners' stock. This income did not disappear with the subsequent distribution of 1976 earnings and profits, but remains in the capital structure of the corporation and may be distributed to petitioners in any future year in which the corporation has insufficient current or accumulated earnings and profits to cause part or all of any such distribution to be classed as a dividend under section 316, with a corresponding step-down in petitioners' stock basis. In the event no such distribution ever becomes possible, the amount of the locked-in earnings will nevertheless serve to reduce petitioners' gain upon liquidation of the corporation or sale by petitioners of their stock. (42 T.C.M. at 554, 50 P-H Memo T.C. par. 81,397 at 1458-81)

Also with regard to petitioner's double taxaton argument, see Note, "'Locked-In Earnings'—How Serious A Problem Under Subchapter S?," 49 Va. L. Rev. 1516, 1526-1530 (1963).

For the foregoing reasons,

Decision will be entered under Rule 155.